In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-650

CHARLES SCHNEIDER & CO., ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioners challenge the factual finding of the Tax Court, which the court of appeals affirmed, that a portion of the amounts paid by Charles Schneider & Co., Inc., and Future Foam, Inc., under contingent compensation agreements were unreasonably large and thereby not deductible under Section 162(a) of the Internal Revenue Code of 1954.

In 1963, petitioners entered into compensation agreements with their respective chief executive officers pursuant to which each officer was to be paid a weekly salary plus a bonus determined as a percentage of the net profits. In effect, the agreements provided for the distribution of virtually all of each petitioner's net profits, except for amounts denominated "retained earnings" (equal to 2 percent of net sales) (Pet. App. B 50-51, 54-55, 70-71). At the time the agreements were executed, Charles Schneider owned all the outstanding stock and was a chief executive

officer of each petitioner. The other chief executive officers participating in the contingent compensation plans had, however, been granted options to aquire stock, and two of the three had exercised those options to acquire stock, prior to the years here in question. All of the recipients of the contingent compensation approved the compensation agreements on behalf of the petitioners in their capacities as officers and directors (Pet. App. B 36-37, 46-47, 49-51, 53-55).

The following table shows the amounts paid by petitioners pursuant to these agreements during the years in question, the deductions allowed by the Commissioner, and the amounts found by the Tax Court to be deductible as reasonable compensation for the services (Pet. App. B 51, 56, 64-65, 73-74):

	Amounts paid by petitioners	Deduction allowed by Commissioner	Deduction allowed by Tax Court
Charles Schneider & Co.—1966:			
Charles Schneider	$65,104.94	$35,000	$40,000
Leon Summer	74,414.50	50,000	60,000
Charles Schneider & Co.—1967:			
Charles Schneider	$59,052.98	$35,000	$40,000
Leon Summer	66,357.95	50,000	60,000
Charles Schneider & Co.—1968:			
Charles Schneider	$65,000.00	$35,000	$40,000
Leon Summer	74,089.36	50,000	60,000
Future Foam—1966:			
Charles Schneider	$45,000.00	$35,000	$40,000
William Grassman	80,176.00	50,000	65,000
Sol Friedman	80,176.00	50,000	65,000
Future Foam—1967:			
Charles Schneider	$45,780.00	$35,000	$40,000

The court of appeals affirmed, concluding that the Tax Court's findings were based on substantial evidence (Pet. App. A 29-42).

1. Section 162(a) of the Code permits the deduction of ordinary and necessary business expenses including "a reasonable allowance for salaries or other compensation for personal services actually rendered." To be deductible, such compensation must be both reasonable and in fact paid purely for services. Treasury Regulations, Section 1.162-7(a). Petitioners paid no dividends during any of the years the compensation agreements were in effect. Indeed, the compensation agreements themselves virtually assured that nearly all of the petitioners' increasing profits would be distributed in the form of bonuses to Schneider, Summer, Grassman and Friedman.

But, as both lower courts noted (Pet. App. A 38; Pet. App. B 73), shareholders of corporations enjoying profits as consistent and substantial as petitioners' would certainly expect some return on their investment. The absence of dividends justified the inference that some of the purported compensation represented a distribution of profits. See *McCandless Tile Service* v. *United States,* 422 F. 2d 1336, 1340 (Ct. Cl.); *Pacific Grains, Inc.* v. *Commissioner,* 399 F.2d 603, 606 (C.A. 9).

Moreover, the compensation paid by petitioners to these officers was also found far to exceed the amounts paid by comparable concerns for comparable services. Exhibits reflecting statistics for the furniture making industry demonstrated that the compensation in question greatly ex-

---

[1]Future Foam also paid Grassman and Friedman $31,874 each for its taxable year 1967 (Pet. App. B 57). However, its deduction of those amounts is not in question in this case.

ceeded the industry-wide averages for executive compensation, although petitioners fell significantly below the industry averages both in size and sales volume (Pet. App. B 41).[2] This evidence substantially controverted the vague and general testimony of petitioners' expert witnesses or any inference which might be drawn from the fact that the agreements were approved by petitioners' respective boards of directors. See *East Tennessee Motor Co.* v. *United States,* 453 F.2d 494 (C.A. 6).

In any event, contrary to petitioners' contention (Pet. 21-24), even the testimony of their expert witnesses did compel not a finding in their favor on this issue. The Tax Court has the duty to weigh all of the evidence to determine whether the petitioners satisfied their burden of establishing the reasonableness of these salaries. See *Lakewood Manufacturing Company* v. *Commissioner,* 453 F.2d 451, 454 (C.A. 6).

2. Recognizing the factual nature of the "reasonable compensation" question (see *e.g., Mayson Mfg. Co.* v. *Commissioner,* 178 F.2d 115, 119 (C.A. 6); *Hammond Lead Products, Inc.* v. *Commissioner,* 425 F.2d 31, 33 (C.A. 7)), petitioners concede (Pet. 13-14) that the "clearly erroneous" rule announced by this Court in *Commissioner* v. *Duberstein,* 363 U.S. 278, was the proper standard of review to be applied by the court of appeals. See also *East Tennessee Motor Co.* v. *United States, supra,* 453 F.2d

---

[2]Indeed, one of petitioners' sister corporations, Charles, Inc., with comparable sales and assets, paid considerably lower amounts to its officers and offered far more modest incentive compensation agreements than did petitioners (Pet. App. A 40; Pet. App. B 59-60, 62-63). During the years in issue, petitioners paid out from about 70 percent to about 90 percent of their before-tax income as compensation to their officers. Charles, Inc., on the other hand, paid out less than 30 percent of its profits as compensation to its officers (Pet. App. B 62-63).

at 496.[3] Nevertheless, petitioners contend (Pet. 24-26) that these salaries should have been found to be reasonable under Section 1.162-7 of the Regulations.

But the Regulations simply provide that amounts paid pursuant to contingent compensation arrangements are not to be treated any differently from any other type of compensation, and that a deduction may be allowable only so long as it results from free bargaining between the employer and the individual "not influenced by any consideration on the part of the employer other than that of securing [such individual's services] on fair and advantageous terms * * *." Treasury Regulations, Section 1.162-7(b)(2). Indeed, that provision of the Regulations expressly states that such arrangements are subject to close scrutiny to insure that such contingent compensation is not actually a distribution of corporate earnings and that, at all events, the allowance for compensation of any form may not exceed what is reasonable under all the circumstances existing at the time the contract was made. Treasury Regulations, Section 1.162-7(b)(2) and (3). Thus, while the fact that the salaries were contingent may be one factor to be considered, that fact does not preclude the courts from examining all the circumstances to determine whether the contracts actually provided for payment of reasonable compensation for services actually rendered.

---

[3]Given the factual nature of the question of unreasonable compensation, the decision below does not conflict with the cases cited by petitioners (Pet. 26), all of which turn on their own peculiar facts.

Contrary to petitioners' argument (Pet. 24-26), the court of appeals did not ignore Section 1.162-7(b)(3) of the Regulations, which provides that the circumstances to be taken into account are those existing when the contract for services is made and not when the contract is questioned. The courts below considered the circumstances existing at the time the compensation agreements were executed and concluded that the compensation agreements were not a result of free bargaining between petitioners and its officers, and that the bonus plans from their very inception constituted a "built-in mechanism" for the distribution of future profits without relation to the services to be performed (Pet. App. A 36-37; Pet. App. B 71).[4]

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

JANUARY 1975.

---

[4]While petitioners contend (Pet. 20) that these contingent compensation agreements were necessary to obtain the best efforts of their officers, none of petitioners' other employees were offered such incentive agreements. And, as both courts below noted (Pet. App. A 36-37; Pet. App. B 71-72), none of these executives needed such incentives to elicit his best efforts, since the value of their actual and potential shareholdings itself would serve to motivate such efforts.